ZARGON OIL & GAS LTD.

Second Quarter Report 2002

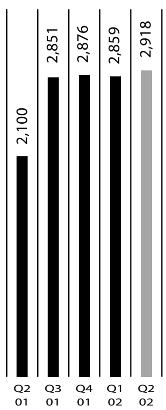
CORPORATE HIGHLIGHTS

Zargon Oil & Gas Ltd. has recorded second quarter cash flow of $7.47 million, or $0.42 per share diluted, and posted earnings of $2.55 million, or $0.14 per share diluted. These results were generated with an average production rate of 6,085 barrels per day of equivalent (6:1), which represented a 17 percent gain over the second quarter 2001 volumes, but was essentially unchanged from first quarter 2002 levels. Despite the higher production volumes, as compared to the prior year period this year's second quarter revenue, cash flow and earnings declined by 8, 13 and 27 percent respectively, due to quarterly commodity price declines of 3 percent for oil and liquids and 40 percent for natural gas.

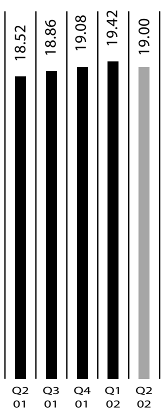
The second quarter was highlighted by the June 17, 2002 acquisition of the private company, Hadrian Energy Corp. for $9.60 million ($7.39 million attributed to property and equipment). During the quarter Zargon continued to focus on building its undeveloped gas exploration land inventory and related prospects as evidenced by a 33 percent year over year increase in undeveloped lands to 290,600 net acres. Capital expenditures in the second quarter excluding the Hadrian transaction were limited to $3.84 million with spring break-up curtailing drilling to 2.0 net wells. At quarter-end Zargon's balance sheet remains strong with bank indebtedness plus working capital deficiency totaling $28.18 million, just over 12 months of cash flow at first half 2002 annualized rates.

	Three Months Ended June 30,			Six Months Ended June 30,		
(unaudited)	**2002**	2001	% Change	**2002**	2001	% Change
FINANCIAL						
Income and Investments ($ million)						
Production revenue	**15.50**	16.90	(8)	**28.23**	37.94	(26)
Cash flow from operations	**7.47**	8.59	(13)	**13.66**	19.20	(29)
Earnings	**2.55**	3.49	(27)	**4.13**	8.77	(53)
Net capital expenditures	**11.23**	7.85	43	**16.57**	16.08	3
Per Common Share, Diluted						
Cash flow from operations ($/share)	**0.42**	0.57	(26)	**0.78**	1.28	(39)
Earnings ($/share)	**0.14**	0.22	(36)	**0.24**	0.58	(59)
Balance Sheet at Period End ($ million)						
Property and equipment, net				**129.43**	85.88	51
Bank indebtedness				**28.00**	13.19	112
Shareholders' equity				**79.69**	65.55	22
Shares Outstanding at Period End (million)				**17.53**	14.59	20
OPERATIONS						
Average Daily Production						
Crude oil and liquids (bbl/d)	**2,918**	2,100	39	**2,889**	2,013	44
Natural gas (mmcf/d)	**19.00**	18.52	3	**19.21**	18.37	5
Equivalents (boe/d 6:1)	**6,085**	5,187	17	**6,091**	5,074	20
Equivalents (boe/d 10:1)	**4,818**	3,952	22	**4,810**	3,850	25
Average Selling Price (before hedges)						
Crude oil and liquids ($/bbl)	**35.15**	36.40	(3)	**31.78**	36.65	(13)
Natural gas ($/mcf)	**3.56**	5.92	(40)	**3.34**	7.40	(55)
Wells Drilled, Net	**2.0**	3.7	(46)	**7.1**	23.3	(70)
Undeveloped Land at Period End (thousand net acres)				**291**	218	33

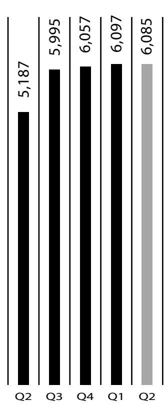
Crude Oil and Liquids Production *(bbl/d)*



Natural Gas Production *(mmcf/d)*



Production *(boe/d 6:1)*



PRODUCTION

Production of oil and liquids averaged 2,918 barrels per day during the second quarter of 2002, a 39 percent increase over the 2,100 barrels per day reported in second quarter 2001, and a 2 percent improvement over the 2002 first quarter rate of 2,859 barrels per day. Zargon has built an oil property portfolio focused on exploitation projects characterized by long life, low decline properties primarily in Southeast Saskatchewan and in adjacent North Dakota counties. Consequently, oil production rates have remained stable during 2002, despite limiting oil related capital expenditures to $3.67 million in the first half of 2002.

Natural gas production averaged 19.00 million cubic feet per day in second quarter 2002, a 3 percent improvement over the 18.52 million cubic feet per day reported in second quarter 2001, but a 2 percent decline from the 2002 first quarter rate of 19.42 million cubic feet per day. These changes originated from Jarrow, Zargon's largest gas property, which averaged 13.94 million cubic feet per day in the 2002 second quarter, compared to a 14.83 million cubic feet per day average rate in the 2002 first quarter. The decreased Jarrow rate related to facility outages, weather related delays in tie-ins of new wells and natural production declines. Recent Jarrow property production rates have returned to the 14.30 million cubic feet per day range, a rate that is forecast to be maintained over the next year by the drilling of one net gas well per month. With steady Jarrow gas volumes, Zargon will look to its West Central Alberta gas exploration and development initiatives to provide the forecasted corporate gas production volume growth.

On an equivalent basis, the 2002 second quarter production of 6,085 barrels of equivalent per day (6:1) climbed 17 percent over the prior year's second quarter rate of 5,187 barrels of equivalent per day. The 2002 second quarter rate was essentially unchanged from the first quarter 2002 rate of 6,097 barrels of equivalent per day. The second quarter production volumes include the benefit of 13 days of production attributed to the acquisition of Hadrian Energy Corp. Although combined production has remained essentially constant over the last four quarters, production growth will resume in the second half of this year.

EXPLORATION AND EXPLOITATION

Including only 2.0 net (1.0 oil and 1.0 gas) wells drilled in the second quarter, Zargon drilled 8 gross (7.1 net) wells in the first half of 2002. This program was comprised of 3.8 net exploratory and 3.3 net development locations and resulted in 5.1 net gas wells and 2.0 net oil wells. This represents a substantial reduction from the 23.3 net wells drilled in the first half of 2001 when Zargon was accelerating production to capture last year's very high natural gas prices. In the first half of this year Zargon focused on building natural gas exploration projects through land and seismic acquisitions instead of pursuing active development drilling programs. Of the six gross gas wells drilled in the half, three were located at Jarrow, two were drilled in the Pembina shallow gas project area and the sixth was at Ukalta in East Central Alberta, one of the new gas properties obtained in the acquisition of Hadrian Energy Corp. Both oil wells were drilled at the Company's Weyburn (Elswick) property in Southeast Saskatchewan.

Zargon's strategy for the first half of 2002 was to focus on building gas exploration opportunities. As was reported earlier, the Hadrian acquisition brought Zargon active operated gas exploration and development areas at Ukalta and at the West Central Alberta areas of Highvale and Judy Creek. Significant progress has also been made through Crown sales and private purchases in the West Central Alberta gas exploration area focused on Pembina and the Peace River Arch, where Zargon has increased its undeveloped acreage nearly four-fold over the last 12 months to 71,800 net acres. With this year's more subdued Crown sale prices, Zargon had a successful first half at Crown sales, purchasing 29,600 net acres of undeveloped lands at an average cost of $50 per acre.

In the second half of 2002, Zargon plans to test many of these gas exploration ideas with the drilling of eleven net wells in West Central Alberta. An additional eight net wells are scheduled for the Jarrow and Hamilton Lake East Central Alberta gas properties. Subsequent to second quarter end, five (4.6 net) wells have been drilled resulting in 1.6 net Jarrow gas wells, 1.0 net Jarrow dry hole and 2.0 net successful gas exploration locations at Judy Creek and Highvale in West Central Alberta.

In the first half of 2002, Zargon continued to make progress with its oil exploitation business. Since last year, Zargon has concluded its geological and reservoir studies at the Haas North Dakota field and has filed an application to convert five wells into water injectors with the North Dakota Industrial Commission. Approvals and field implementation in this pool is anticipated by October. The Haas field provided Zargon 506 barrels per day of production in the second quarter of 2002 and may provide substantial reserve gains if additional recoveries of the estimated 47 million barrels of original oil in place can be obtained. On a smaller scale, a similar waterflood application has been filed with Saskatchewan Industry and Resources for our Frys East property. Zargon continues to pursue engineering related exploitation opportunities on its existing properties and anticipates filing a minimum of one additional waterflood application by year-end. Ongoing oil development activities during the remainder of the year will include four net wells in Southeast Saskatchewan and three net wells at Taber, Alberta.

ACQUISITIONS

The acquisition of Hadrian Energy Corp. closed on June 17, 2002 and the Hadrian assets and field management have been absorbed into Zargon's existing structure. The $9.60 million acquisition was met with a $4.745 million cash payment, transaction costs of $0.112 million and the issuance of 542,340 Zargon shares valued at $8.75 per share. This gas focused acquisition brought Zargon undeveloped gas lands, three operated developable gas properties and substantial surplus tax pools. Since closing the transaction, earning wells have been drilled at the Ukalta, Judy Creek, and Highvale properties. The Hadrian acquisition was accounted for using the purchase method and the purchase price has been allocated as follows:

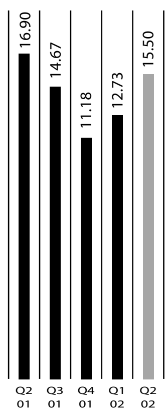
($ thousand)	
Working capital	(816)
Property and equipment	7,386
Future tax asset	3,792
Future site restoration	(760)
	9,602

During the second quarter net property acquisitions of $1.03 million were mostly related to Southeast Saskatchewan oil properties or Alberta undeveloped gas lands. Total property acquisition expenditures in the first half of $2.78 million were allocated 65 percent to the expansion of Southeast Saskatchewan oil exploitation opportunities. In July, Zargon closed the acquisition of an operated Pembina Belly River oil pool in West Central Alberta at a cost of $3.50 million. The purchase brought Zargon approximately 155 barrels of equivalent per day of oil production and related solution gas with interpreted waterflood potential. This acquisition conforms to Zargon's strategy of buying and exploiting oil assets while focusing exploration activities on gas.

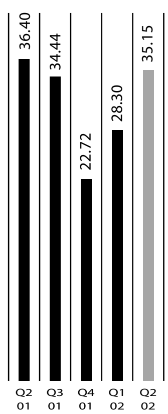
Zargon continues to budget $40 million of capital expenditures for 2002. Twenty-six net wells are scheduled to be drilled in the second half of this year of which 70 percent relate to gas opportunities. This program represents a large increase over the quiet first half drilling program of 7.1 net wells. Year-end exit production rates will depend to a large extent on the success and the tie-in scheduling of the upcoming drilling program. In the last quarterly report, Zargon provided year-end exit rate guidance of 25 million cubic feet per day of natural gas and 3,200 barrels of oil per day. Since then, we have experienced delays in the development of the Pembina shallow gas property and now anticipate an on stream production date by spring 2003. Also, the stabilized Jarrow natural gas production rate is somewhat lower than anticipated. Consequently, we are revising our year-end exit rate natural gas guidance to 23.5 million cubic feet per day, but are maintaining the oil and liquid production exit rate guidance at 3,200 barrels per day. Some of these forecasted production gains will not occur until late in the fourth quarter.

MANAGEMENT'S DISCUSSION AND ANALYSIS

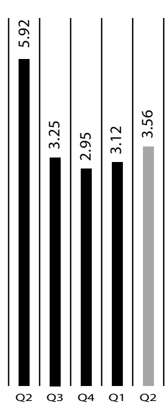
Production Revenue
($ million)



Oil and Liquids Prices
($/bbl)



Natural Gas Price
($/mcf)



Management's discussion and analysis (MD&A) should be read in conjunction with the unaudited consolidated interim financial statements for the three and six months ended June 30, 2002 and the audited consolidated financial statements and MD&A for the year ended December 31, 2001. The calculation of barrels of equivalent (boe) is based on the conversion ratio of one barrel of oil as equivalent to six thousand cubic feet of natural gas unless otherwise indicated.

FINANCIAL ANALYSIS

In the second quarter of 2002, production of oil and gas equivalents rose 17 percent over the prior year quarter but oil prices were down 3 percent and gas prices down 40 percent, and the overall impact on revenue was a decrease of 8 percent. Because the first quarter of 2001 had exceptional gas pricing, a year over year comparison of the first six months shows a similar relationship with production of equivalents up 20 percent over the prior year but revenue down 26 percent.

Zargon's field oil and liquids price of $35.15 per barrel in the second quarter was 3 percent below the 2001 quarter but represented an increase of 24 percent over the preceding first quarter. For the six months, Zargon's field oil price of $31.78 per barrel in 2002 was 13 percent below the same prior year period. Comparing second quarters, Zargon's field gas price fell 40 percent to $3.56 per thousand cubic feet in 2002 from $5.92 per thousand cubic feet in 2001 and for the six months it declined 55 percent from the prior year to an average of $3.34 per thousand cubic feet in 2002. Zargon's field oil price was assisted in 2002 by a continued decline in the transportation and quality differential applied to our blended field stream which peaked in the fourth quarter of 2001 at $8.39 per barrel, declined to $5.30 per barrel in the first quarter of 2002 and averaged $4.97 per barrel in the 2002 second quarter.

Zargon maintains an active commodity price risk management program by using forward sales, options and costless collars for up to 30 percent of our net oil and gas volumes. In the second quarter this hedging program resulted in a small net gain of $0.01 million as commodity prices increased, following a much larger gain in the first quarter of $0.92 million. Going in to the second half of 2002, Zargon has outstanding oil swaps for 400 barrels per day at $24.75 US per barrel, an oil collar for 300 barrels per day at a put/call of $23.00/28.15 US per barrel, and gas swaps of 5.03 million cubic feet per day at an average price of $4.06 per thousand cubic feet.

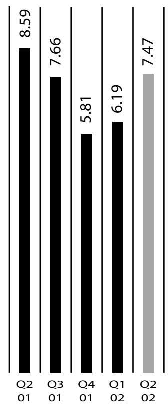
Royalties, inclusive of Alberta royalty tax credit and Saskatchewan resource surcharge, were $3.22 million in the second quarter of 2002, down 20 percent from $3.99 million in the 2001 quarter but up 15 percent from the 2002 first quarter, tracking the swings in revenue. For the first six months of 2002, royalties of $6.01 million were down 29 percent from the prior year half. As a percentage of gross revenue, second quarter 2002 royalties were 20.8 percent of revenue, down slightly from the 22.0 percent reported in the first quarter of 2002 and the 23.6 percent reported in second quarter 2001.

Production expenses in the second quarter of 2002 were $3.48 million, virtually unchanged from $3.46 million in the first quarter but 27 percent higher than $2.73 million reported in the 2001 second quarter. For the 2002 first half, production expenses were $6.93 million, an increase of 33 percent over the 2001 expense of $5.22 million. The increase was caused in part by a 20 percent increase in production for the half. On a unit of production basis, costs were $6.28 per barrel of equivalent in the 2002 second quarter versus the $6.30 per barrel reported in the first quarter and $5.79 per barrel of equivalent in the 2001 second quarter. The higher unit costs are due in large part to the increased oil production attributed to the mid-year 2001 acquisition of Herc Oil Corp. Zargon continues to focus on reducing production costs through field-related cost containment initiatives and the proposed fall 2002 sale of a package of minor, higher cost Southeast Saskatchewan properties.

Operating Netbacks

Six months ended June 30	**2002**		2001	
	Oil and Liquids $/bbl	**Natural Gas $/mcf**	Oil and Liquids $/bbl	Natural Gas $/mcf
Revenue	**31.78**	**3.34**	36.65	7.40
Hedging	**0.70**	**0.16**	(0.89)	(0.38)
Royalties	**(6.29)**	**(0.78)**	(7.24)	(1.75)
Operating costs	**(9.00)**	**(0.64)**	(8.66)	(0.62)
Operating netbacks	**17.19**	**2.08**	19.86	4.65

Cash Flow from Operations
($ million)



Earnings
($ million)

General and administrative costs in the second quarter of 2002 were $0.93 million compared to $0.84 million in the first quarter of 2002 and $0.77 million in the 2001 second quarter. On a unit basis general and administrative costs were $1.68 per barrel of equivalent in the 2002 second quarter versus $1.54 per barrel of equivalent in the first quarter and $1.64 per barrel of equivalent in the prior year's second quarter. The 2002 second quarter costs were higher due in part to a low level of overhead recoveries generated from the small second quarter field capital program. The general and administrative unit costs should decline in the second half of 2002 as Zargon substantially expands its drilling program and adds production volumes.

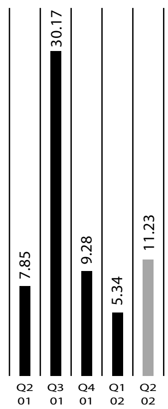
Corporate Netbacks

Six months ended June 30	**2002**	2001
	$/boe 6:1	$/boe 6:1
Revenue	**25.61**	41.33
Hedging	**0.84**	(1.72)
Royalties	**(5.45)**	(9.22)
Operating costs	**(6.29)**	(5.68)
Operating netbacks	**14.71**	24.71
General and administration	**(1.61)**	(1.62)
Financing charges	**(0.49)**	(0.45)
Capital and current income taxes	**(0.22)**	(1.72)
Cash flow netbacks	**12.39**	20.92
Depletion and depreciation	**(5.62)**	(5.01)
Site restoration and reclamation	**(0.56)**	(0.47)
Foreign exchange	**(0.01)**	–
Future income taxes	**(2.45)**	(5.89)
Net earnings	**3.75**	9.55

Depletion and depreciation expense for the second quarter of 2002 was $3.11 million, close to the $3.08 million reported in the first quarter ($5.62 per barrel of equivalent) and 30 percent above the 2001 second quarter of $2.39 million ($5.05 per barrel of equivalent). The higher charges compared to 2001 reflect increased production volumes and higher per unit charges relating to the higher finding and development costs experienced by Zargon and other industry members in 2001.

Cash flow and earnings in the second quarter of 2002 of $7.47 million and $2.55 million increased 21 percent and 61 percent respectively over the first quarter as both oil and gas prices rose while production volumes were unchanged. However, in comparison to the 2001 second quarter with much higher gas prices, cash flow was down 13 percent and earnings declined 27 percent despite a 17 percent gain in production volumes. For the 2002 first half, cash flow was off 29 percent and earnings declined 53 percent for the prior year period, which included an exceptional first quarter. Despite these declines, Zargon's after tax annualized return on book equity in the current three month reporting period averaged 14 percent.

Net Capital Expenditures
($ million)



Capital Expenditures

Six months ended June 30 ($ million)	**2002**	2001
Undeveloped land	**1.64**	2.83
Geological and geophysical (seismic)	**1.18**	2.16
Drilling and completion of wells	**2.64**	9.05
Well equipment and facilities	**0.94**	2.39
Exploration and development	**6.40**	16.43
Property acquisitions	**2.86**	1.65
Property dispositions	**(0.08)**	(2.00)
Net property acquisitions	**2.78**	(0.35)
Hadrian acquisition assigned to property and equipment	**7.39**	–
Total capital expenditures (net)	**16.57**	16.08

LIQUIDITY AND CAPITAL RESOURCES

During the second quarter, Zargon's capital program was dominated by the $9.60 million acquisition of Hadrian Energy Corp. Net capital expenditures for the quarter were $11.23 million compared to $5.34 million in the first quarter and $7.85 million in the 2001 second quarter. For the 2002 first half, total capital expenditures were $16.57 million and were similar to the $16.08 million of expenditures recorded in the 2001 first half. At June 30, 2002, Zargon's balance sheet remains very strong with the bank indebtedness plus working capital deficiency amounting to $28.18 million, which equals just over 12 months of annualized first half 2002 cash flow.

As at August 22, 2002, Zargon has issued 17,526,000 common shares and has granted stock options to acquire an additional 1,327,000 shares.

Capital Sources

Six months ended June 30 ($ million)	**2002**	2001
Cash flow from operations	**13.66**	19.20
Changes in working capital and other	**(6.53)**	(14.32)
Bank indebtedness	**3.86**	(2.72)
Issuance of common shares	**5.58**	13.92
Total capital sources	**16.57**	16.08

OUTLOOK

The outlook for Zargon remains positive. For the second half of 2002, Zargon is budgeting to spend more than $23 million of capital expenditures allocated primarily to promising gas exploration opportunities. Strong commodity prices provide solid cash flows, which in combination with low debt levels will permit Zargon to aggressively pursue oil exploitation or gas exploration opportunities with an expanded capital budget where acceptable values are realizable.

($ million, except per share amounts)

Quarter	Earnings	Earnings/ Diluted Share	Cash Flow	Cash Flow/ Diluted Share	Revenue	Total Assets	Bank Debt
2002 Q2	$2.55	$0.14	$7.47	$0.42	$15.50	$137.76	$28.00
2002 Q1	$1.58	$0.09	$6.19	$0.36	$12.73	$128.97	$25.26
2001 Q4	$1.77	$0.10	$5.81	$0.34	$11.18	$127.93	$24.14
2001 Q3	$2.60	$0.15	$7.66	$0.44	$14.67	$119.06	$19.27
2001 Q2	$3.49	$0.22	$8.59	$0.57	$16.90	$108.27	$13.19
2001 Q1	$5.28	$0.36	$10.61	$0.71	$21.04	$90.91	$10.09
2000 Q4	$4.75	$0.32	$10.93	$0.74	$19.32	$86.88	$15.90
2000 Q3	$2.89	$0.19	$7.17	$0.48	$14.24	$74.61	$17.63
2000 Q2	$1.85	$0.13	$5.04	$0.35	$10.62	$68.53	$19.44

"Signed" C.H. Hansen
President and Chief Executive Officer

Calgary, Alberta
August 22, 2002

CONSOLIDATED BALANCE SHEETS

($ thousand)	June 30, 2002 (unaudited)	December 31, 2001
ASSETS		
Current		
Cash	**–**	201
Accounts receivable	**7,691**	7,990
Prepaid expenses and deposits	**636**	741
	8,327	8,932
Property and equipment, net	**129,434**	118,994
	137,761	127,926
LIABILITIES		
Current		
Accounts payable and accrued liabilities	**8,505**	12,440
Bank indebtedness (note 4)	**27,999**	–
	36,504	12,440
Long-term debt (note 4)	**–**	24,137
Future site restoration	**4,471**	3,141
Future income taxes	**17,095**	18,223
	58,070	57,941
SHAREHOLDERS' EQUITY		
Share capital (note 5)	**40,642**	35,066
Retained earnings	**39,049**	34,919
	79,691	69,985
	137,761	127,926

See accompanying selected notes.

CONSOLIDATED STATEMENTS OF INCOME AND RETAINED EARNINGS

(unaudited) ($ thousand, except per share amounts)	Three Months Ended June 30, 2002	2001	Six Months Ended June 30, 2002	2001
Income				
Oil and gas sales	**15,498**	16,904	**28,226**	37,939
Hedging	**10**	(560)	**934**	(1,582)
Royalties	**(3,216)**	(3,994)	**(6,010)**	(8,469)
	12,292	12,350	**23,150**	27,888
Expenses				
Production	**3,475**	2,733	**6,931**	5,215
Administration	**929**	772	**1,773**	1,484
Interest	**274**	171	**541**	412
Foreign exchange	**13**	–	**9**	–
Site restoration	**310**	223	**617**	432
Depreciation and depletion	**3,112**	2,385	**6,196**	4,596
	8,113	6,284	**16,067**	12,139
Income Before Income Taxes	**4,179**	6,066	**7,083**	15,749
Income Taxes				
Future	**1,490**	2,500	**2,710**	5,405
Current	**141**	79	**243**	1,577
	1,631	2,579	**2,953**	6,982
Net Income for the Period	**2,548**	3,487	**4,130**	8,767
Retained Earnings, Beginning of Period	**36,501**	27,089	**34,919**	21,855
Repurchase of Common Shares	**–**	(25)	**–**	(71)
Retained Earnings, End of Period	**39,049**	30,551	**39,049**	30,551
Earnings Per Common Share				
Basic	**0.15**	0.24	**0.24**	0.61
Diluted	**0.14**	0.22	**0.24**	0.58

See accompanying selected notes.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited) ($ thousand, except per share amounts)	Three Months Ended June 30, **2002**	2001	Six Months Ended June 30, **2002**	2001
Operating Activities				
Net income for the period	**2,548**	3,487	**4,130**	8,767
Add non-cash items:				
Depreciation and depletion	**3,112**	2,385	**6,196**	4,596
Site restoration	**310**	223	**617**	432
Foreign exchange	**13**	–	**9**	–
Future income taxes	**1,490**	2,500	**2,710**	5,405
Cash flow from operations	**7,473**	8,595	**13,662**	19,200
Changes in non-cash working capital	**(563)**	(13,935)	**(689)**	(11,620)
	6,910	(5,340)	**12,973**	7,580
Financing Activities				
Bank indebtedness	**2,739**	3,093	**3,862**	(2,716)
Issuance of special warrants	**–**	14,100	**–**	14,100
Issuance of common shares	**279**	337	**918**	694
Share issue costs	**–**	(768)	**–**	(768)
Repurchase of common shares	**–**	(70)	**–**	(104)
	3,018	16,692	**4,780**	11,206
Investing Activities				
Acquisition of property and equipment	**(3,930)**	(7,845)	**(9,332)**	(18,081)
Disposal of property and equipment	**22**	–	**82**	2,002
Acquisition of Hadrian Energy Corp. (cash portion)	**(4,857)**	–	**(4,857)**	–
Site restoration expenditures	**(34)**	(192)	**(47)**	(194)
Changes in non-cash working capital	**(1,129)**	(3,297)	**(3,800)**	(2,502)
	(9,928)	(11,334)	**(17,954)**	(18,775)
Increase (decrease) in Cash	**–**	18	**(201)**	11
Cash, Beginning of Period	**–**	152	**201**	159
Cash, End of Period	**–**	170	**–**	170
Cash interest paid	**376**	171	**767**	412
Cash taxes paid	**140**	79	**242**	177
Cash Flow from Operations Per Share				
Basic	**0.44**	0.59	**0.81**	1.33
Diluted	**0.42**	0.57	**0.78**	1.28
Weighted Average Number of Shares (million)				
Basic	**17.03**	14.53	**16.89**	14.44
Diluted	**17.67**	15.21	**17.50**	15.74

See accompanying selected notes.

SELECTED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the three and six months ended June 30, 2002 and June 30, 2001 (unaudited)

1. BASIS OF PRESENTATION

The interim consolidated financial statements of Zargon Oil & Gas Ltd. (the "Corporation") have been prepared by management in accordance with Canadian generally accepted accounting principles. The interim consolidated financial statements have been prepared following the same accounting policies and methods in computation as the consolidated financial statements for the fiscal year ended December 31, 2001. The interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto in the Corporation's annual report for the year ended December 31, 2001.

2. CHANGES IN ACCOUNTING POLICIES

Business Combinations

Effective January 1, 2002, the Corporation adopted the new Canadian Institute of Chartered Accountants ("CICA") standard for goodwill and other intangibles. Under the new standard, goodwill and certain intangibles are no longer subject to amortization, but are instead tested for impairment at least annually. The Corporation has assessed the application of this policy with respect to its intangible assets and determined that there is no reclassification required, and no impact on the carrying values of its assets, or net income for the period or earnings per share for the period ended June 30, 2002.

Stock Based Compensation

Effective January 1, 2002, the Corporation adopted the new CICA 3870 standard for reporting stock-based compensation. As permitted by the CICA 3870, the Corporation has applied this change prospectively for all new awards granted after January 1, 2002. The Corporation has chosen to recognize no compensation when stock options are granted to employees and directors under the stock option plan that has no cash settlement features. However, direct awards of stock to employees and directors, and stock and stock option awards granted to non-employees will be accounted for in accordance with the fair value method of accounting for stock-based compensation. The fair value of direct awards of stock are determined by the quoted market price of the Corporation's stock and the fair value of stock options are determined using the Black-Scholes option pricing model.

In periods prior to January 1, 2002, the Corporation recognized no compensation when stock or stock options were granted to employees. Pro forma information regarding net income is required and has been determined as if the Corporation has accounted for its employee stock options granted after December 31, 2001 under the fair value method. The fair value for these options was estimated at the date of grant using a Black-Scholes Option Pricing Model with the following assumptions for 2002:

Volatility factor of expected market price (%)	18.2
Weighted average risk-free interest rate (%)	4.74
Dividend yield (%)	0
Weighted average expected life of options (years)	4

For purposes of pro forma disclosures, the estimated fair value of options is amortized to expense over the options' vesting periods. The Corporation's pro forma net income would be reduced by $163 thousand for the three months ended June 30, 2002 and $300 thousand for the six months ended June 30, 2002. Basic and diluted earnings per share figures would have been reduced by $0.01 and $0.01 respectively for the quarter and by $0.02 and $0.02 for the half.

3. ACQUISITIONS

On June 17, 2002, the Corporation acquired all of the outstanding shares of Hadrian Energy Corp. ("Hadrian"), a private oil and gas company, for $9.60 million. Consideration consisted of $4.745 million cash and the issuance of 542,340 Zargon common shares valued at $8.75 per share. Costs of $0.112 million were incurred to effect the transaction and were charged to share capital. The acquisition was accounted for by the purchase method and the purchase price has been allocated as follows:

($ thousand)	
Working capital	(816)
Property and equipment	7,386
Future tax asset	3,792
Future site restoration	(760)
Total consideration	9,602

4. BANK INDEBTEDNESS

The Corporation has a $50 million credit facility consisting of a revolving demand loan with a Canadian chartered bank that bears interest at the bank's prime rate. The Corporation has pledged an assignment of accounts receivable, a first floating charge on all of the Canadian assets and a fixed charge over certain property and equipment as collateral under this facility. The Corporation also has a revolving demand loan in the United States for $4.3 million (U.S.) bearing interest at U.S. prime plus 3/4 percent and has pledged a first floating charge on all of the U.S. assets and a fixed charge over certain U.S. property and equipment as collateral.

Effective January 1, 2002, the Corporation adopted the recommendations of the Emerging Issues Committee of the Canadian Institute of Chartered Accountants concerning the presentation of revolving demand loans. These new recommendations require that the classification of debt in a debtor's balance sheet be based upon the facts existing at the balance sheet date rather than expectations. Prior to the adoption of the new recommendations, the Corporation presented the demand loan as long-term on the basis that the bank had indicated it was not its intention to call for repayment within one year provided there was no adverse change in the financial position of the Corporation. However, these loans are demand in nature and therefore are now presented as a current liability.

5. SHARE CAPITAL

The Corporation is authorized to issue an unlimited number of common shares and an unlimited number of first preferred shares and second preferred shares.

Common shares:

(thousand)	**June 30, 2002**		June 30, 2001	
	Number of Shares	**Amount $**	Number of Shares	Amount $
Shares issued,				
Balance, beginning of year	**16,666**	**35,066**	14,315	20,667
Shares issued for Hadrian	**542**	**4,658**	–	–
Stock options exercised	**317**	**918**	298	694
Normal course issuer bid	**–**	**–**	(23)	(34)
	17,525	**40,642**	14,590	21,327
Shares to be issued:				
Special warrants	**–**	**–**	2,000	13,668
	17,525	**40,642**	16,590	34,995

A summary of the status of the Corporation's stock option plans as at June 30, 2002 and 2001, and changes during the six months ended on those dates is presented below:

Stock options:	**June 30, 2002** Number of Shares (thousand)	**June 30, 2002** Weighted Average Exercise Price $	June 30, 2001 Number of Shares (thousand)	June 30, 2001 Weighted Average Exercise Price $
Outstanding at beginning of year	**1,199**	**3.36**	1,290	2.71
Granted	**449**	**7.65**	278	4.78
Exercised	**(317)**	**2.90**	(298)	2.33
Cancelled	**(3)**	**7.25**	(15)	4.28
Outstanding at end of period	**1,328**	**4.91**	1,255	3.24
Options exercisable at period end	**863**	**3.43**	937	2.76

6. SEGMENTED INFORMATION

($ thousand)	Three Months Ended June 30, **2002**	Three Months Ended June 30, 2001	Six Months Ended June 30, **2002**	Six Months Ended June 30, 2001
Oil and Gas Sales				
Canada	**13,757**	16,904	**25,092**	37,939
United States	**1,741**	–	**3,134**	–
Total	**15,498**	16,904	**28,226**	37,939
Total Assets				
Canada			**133,068**	118,994
United States			**4,693**	–
Total			**137,761**	118,994

ZARGON OIL AND GAS LTD.

Corporate Information

Board of Directors

Craig H. Hansen
K. James Harrison
H. Earl Joudrie
Kyle D. Kitagawa
John O. McCutcheon
James D. Peplinski
Byron J. Seaman
William J. Whelan
Grant A. Zawalsky

Officers

John O. McCutcheon
Chairman

Craig H. Hansen
President and
Chief Executive Officer

Mark I. Lake
Vice President, Exploration

Daniel A. Roulston
Vice President, Operations

Sheila A. Wares
Vice President, Accounting

Kenneth W. Young
Vice President, Land

Key Personnel

J. Yves Gauthier
Manager, Exploitation

Andrea P. Henry
Senior Geologist

John D. Sorkilmo
Senior Geologist

Neil D. Watson
Senior Geologist

Stuart A. Wilson
Production Manager, North

Stock Exchange Listing

Toronto Stock Exchange
Trading Symbol: ZAR

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